

### **III. Analysis of the RBOCS' Behavior in the Post-Merger Environment**

As explained in Chapter 2 of this report, the SBC/Pacific Telesis and Bell Atlantic/NYNEX mergers were approved, subject to the merged companies' fulfillment of certain conditions. While the particular conditions varied from jurisdiction to jurisdiction, the most important conditions focused on the mergers' potential impacts in the following areas:

- The opening of local telephone service markets to competition, including the removal of barriers to entry by new suppliers;
- The incumbents' retail price levels and flow through of merger cost savings; and
- The incumbents' retail service quality and pace of network investment.

This chapter examines the merged companies' performance in each of these areas in turn and begins to answer the question of whether they have in fact met their commitments to regulators. It should be borne in mind that both mergers are relatively recent events: the SBC/Pacific Telesis merger has been in place for less than two years, and the Bell Atlantic/NYNEX merger has existed for about a year and a half. Given the huge scale and complexity of these four RBOCs, it will likely take several more years for the full impact of their mergers to be felt by customers and competitors. Nevertheless, this preliminary analysis provides some empirical data concerning the short-term successes and problems of the first mergers and may help to identify important issues bearing on the regulatory reviews of other pending and future merger proposals.

#### **Competition in Local Telephone Service Markets**

At the time of their applications for merger approvals by state regulators, the candidate RBOC companies asserted that the mergers would be pro-competitive and would increase consumers' service choices. For example, an economist testifying on behalf of SBC and Pacific Telesis in support of those companies' California PUC merger application concluded that "the merger is procompetitive not only in the interLATA market but in the

local exchange market as well.”<sup>58</sup> Similarly, another RBOC-sponsored economist who supported the Bell Atlantic/NYNEX merger contended that “it is likely that consumers in evolving local exchange markets will demand traditional services and new bundles of telecommunications services of higher quality and more diversity than are presently available, and the proposed merger will increase NYNEX’s ability to respond to these demands.”<sup>59</sup>

No doubt in part because it was the first RBOC merger that was considered, SBC/Pacific was not subject to any specific commitments to reduce entry barriers or otherwise promote local competition. However, as we note in Chapter 2, the FCC did impose specific conditions on Bell Atlantic in this area, including (1) submitting regular PMRs that detail the company’s performance in the ordering, provisioning, and maintenance of resold services, unbundled elements, and interconnection trunks, and (2) accepting specifications for the establishment and testing of uniform interfaces for carriers to gain access to Bell Atlantic/NYNEX operations support systems (OSS) within 15 months following approval.

After some initial difficulties in producing reports that met the FCC’s requirements,<sup>60</sup> Bell Atlantic has been filing PMRs with the FCC on a quarterly basis. The PMRs track numerous dimensions of the merged companies’ interactions with competitive local exchange carriers (CLECs). One important measure is the “Percent Flow-Through” for the ordering of resold services and unbundled loops, which refers to the percentage of valid CLEC orders received through Bell Atlantic’s electronic ordering interfaces. A successful flow-through is one in which an order is fed into Bell Atlantic’s provisioning systems on an electronic basis, without manual intervention and/or correction by Bell Atlantic personnel. When competitors’ wholesale orders do not flow through Bell Atlantic’s ordering systems, they are subjected to relatively slow and expensive manual handling by the company’s employees, a process that increases their cost and can impair the competitors’ ability to deliver services to their customers in a timely fashion.

## **Regulatory Conditions to Reduce Entry Barriers**

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<sup>58</sup>California PUC Application No. 96-04-038, Direct Testimony of Lewis J. Perl, July 3, 1996, Exhibit 2 (“Economic Benefits of the Pacific Telesis-SBC Merger in California”), at p.30.

<sup>59</sup>Maine PUC Docket No. 96-388, Testimony of William E. Taylor, September 6, 1996, at p.3.

<sup>60</sup>The FCC’s Accounting Safeguards Division initially was critical of the quality of Bell Atlantic’s PMR reports and indicated in a letter to Bell Atlantic that it was “concerned...about the error rates in the submissions Bell Atlantic has filed to date.” Letter from Kenneth P. Moran, Chief, Accounting Safeguards Division, to Ms. Patricia E. Koch, Assistant Vice President, Government Relations – FCC, DA 98-1228 (rel. June 24, 1998).

The latest PMR data (for December 1998) indicate that very few CLEC orders for unbundled loops are passing through Bell Atlantic's OSS without manual intervention.<sup>61</sup> While Bell Atlantic's handling of competitors' orders for bundled wholesale services is better, even in the best-performing states, some 35-50 percent of those orders do not flow through entirely on an electronic basis.<sup>62</sup>

Bell Atlantic's performance on wholesale orders has been substantially better in the former NYNEX territory than in the former Bell Atlantic territory.<sup>63</sup> One would expect a substantial convergence between the two areas, as "best practices" were adopted and OSS was optimized between the two areas. In light of the continued disparity in wholesale ordering performance, such optimization apparently has not yet materialized in this case. Recently, Bell Atlantic has announced that it has achieved uniform electronic OSS interfaces throughout its 14-state region.<sup>64</sup> In the future, Bell Atlantic's upgrading of these systems may eventually increase its electronic ordering efficiency and flow-through rates from the relatively low levels that it has reported to date.

Two other conditions that the FCC attached to its approval of the Bell Atlantic/NYNEX merger were that the merged firm must:

- (1) offer alternative arrangements to reduce the up-front costs (by incorporating the costs into recurring charges or by allowing nonrecurring charges to be paid over a number of months) that competitors would face when obtaining wholesale services and UNEs from the company; and

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<sup>61</sup> Bell Atlantic reported a 22 percent flow-through rate for POTS UNEs in New York, a 4 percent rate in Pennsylvania, and 0 percent in the other twelve states that it operates (including its limited service territory in Connecticut). Two of those states had no ordering activity, and for three others Bell Atlantic did not supply public data because two or fewer CLECs placed orders. Bell Atlantic Performance Monitoring Report, data file downloaded from FCC, [www.fcc.gov/ccb/Mergers/BA\\_NYNEX/perfmon.htm](http://www.fcc.gov/ccb/Mergers/BA_NYNEX/perfmon.htm) (file "ba4q98.exe"), at 7.02.

<sup>62</sup> *Ibid.*, at 7.01. For the latest period (December 1998), the best flow-through rate was achieved in New Hampshire (63 percent), New York was at 50 percent, and Delaware, Maryland, Pennsylvania, Virginia, and D.C. were all under 20 percent.

<sup>63</sup> *Ibid.*, at 7.01. In December 1998, in BA-North states the flow-through rate for resale orders ranged between 40 percent and 63 percent, while in BA-South it ranged between 6 percent and 18 percent.

<sup>64</sup> Report of Bell Atlantic on Compliance with Merger Conditions, February 1, 1999, at 4 (Bell Atlantic Compliance Report). This report can be downloaded from [www.fcc.gov/ccb/Mergers/BA\\_NYNEX](http://www.fcc.gov/ccb/Mergers/BA_NYNEX).

(2) ensure, when it proposes rates for interconnection, transport, and termination, or unbundled network elements, that such rates are based upon the forward-looking, economic cost to provide those items.

Neither of these conditions appears to have been particularly effective. Bell Atlantic indicates that it has made available various installment plans for CLEC payment of nonrecurring charges, but that thus far there has been very little demand for these options.<sup>65</sup> Bell Atlantic also states that all of its proposed prices for interconnection and UNEs, both before and after the merger, have been based on forward-looking economic costs.<sup>66</sup> Whether the CLECs and other parties would agree with the company's assessment is unclear. Moreover, this condition is impractical for the FCC to enforce, since a cost study must be subject to detailed and comprehensive examination to determine whether it meets the standard of forward-looking economic costs.

While Bell Atlantic has made progress in some of the areas necessary to open up its local markets to competition, it has failed to live up to all the promises that it made to state regulators in order to secure approval of its merger with NYNEX. As noted in Chapter 2, in its effort to gain regulatory approval, Bell Atlantic had made commitments to the Maine PUC and the Vermont PSB to satisfy the Act's 14-point local competition checklist by September 30, 1997. More than a year and a half after those original deadlines, neither commission has found Bell Atlantic to have met the checklist's standards for opening local markets to competition.

In the 30-odd months since the two merger announcements, telephone consumers in the regions of the acquired RBOCs have seen little growth in their choices for local telephone service. As documented later in this report, notwithstanding RBOC claims to the contrary, local market entry by new competitive suppliers has been much slower than had been anticipated when the 1996 Act was passed. Various regulatory agencies have documented the role of RBOCs, especially SBC, in making it difficult for new local competitors to enter the market.

## **Market-Preserving Conduct**

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<sup>65</sup> Ibid., at p.11.

<sup>66</sup> Ibid., at p.12.

During a review of SBC's application for Section 271 authority,<sup>67</sup> for example, a Commissioner of the Public Utility Commission of Texas stated that:

...[t]he record is replete with examples of SWB's [Southwestern Bell] failure to meaningfully negotiate, reluctance to implement the terms of the arbitrated agreements, lack of cooperation with customers, and evidence of behavior which obstructs competitive entry.<sup>68</sup>

During the FCC's merger review, AT&T presented evidence that SBC spent \$11 million lobbying against local competition in Texas, and the Intelcom Group, Inc. (ICG), a competitive provider of local telecommunications service, "recites a litany of alleged anticompetitive acts by SBC."<sup>69</sup> The FCC ultimately concluded that none of SBC's alleged misconduct has been found to violate any law.<sup>70</sup> However, when it approved the SBC/Pacific Telesis merger, the FCC made the following observation:

We also find it important that almost all of the acts alleged by AT&T and ICG have occurred in Texas. This indicates that SBC's market-preserving conduct may not have spread throughout its home region (to Arkansas, Kansas, Missouri, and Oklahoma). This gives us some confidence that SBC's acts in Texas, assuming they are anticompetitive, will not be repeated in California and Nevada.<sup>71</sup>

More than two years after that comment, the evidence suggests that SBC has not done enough to eliminate barriers to local competition in the service territory that it acquired in California (served by its Pacific Bell operating company). In December 1998, the CPUC issued its final decision concerning Pacific Bell's request for Section 271 authority.<sup>72</sup> In that decision, the CPUC adopted most of the findings and recommendations from an earlier report prepared by CPUC staff which identified several substantive areas in which Pacific Bell has failed to comply with the competitive mandate embodied in the 1996 Act.<sup>73</sup>

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<sup>67</sup>Section 271 authority is the process whereby a local carrier applies to offer in-region long-distance service.

<sup>68</sup>Statement of Commissioner Judy Walsh Regarding Southwestern Bell's section 271 Request to Enter Long Distance Market, May 21, 1998, at 1.

<sup>69</sup>FCC SBC/Pacific Telesis Merger Decision, at paras. 34-35.

<sup>70</sup>*Ibid.*, at para. 38.

<sup>71</sup>*Ibid.*

<sup>72</sup>CPUC Docket R.93-04-003/1.93-04-002, Decision 98-12-069, December 17, 1998, at 2 and Appendix B.

<sup>73</sup>On March 31, 1998, SBC-Pacific Bell filed a draft application with the CPUC to become a long distance provider pursuant to Section 271 of the Telecommunications Act of 1996. The Final Staff Report represents the conclusions of the CPUC Telecommunications Division staff regarding SBC-Pacific's application.

One conclusion in the Final Staff Report pertains to interconnection agreements. The CPUC Staff determined that "interconnection agreements are not performing as intended by either the Commission or parties to the agreements in question,"<sup>74</sup> and identified as follows three types of problems hindering interconnection agreements from performing as envisioned:

- [T]he provisions in interconnection agreements that allow CLECs to incorporate new network elements and services have not produced timely results. CLECs have found this process too slow for a competitive marketplace and lacking in tangible results.
- Second, the process for resolving contractual disputes is burdensome, time consuming and inconclusive.
- Third, when CLECs seek to amend interconnection agreements, it becomes apparent that they have unequal bargaining power and no recourse to a neutral third party that can authoritatively resolve disputes.<sup>75</sup>

The CPUC staff also concluded, "Pacific has not opened its market to an extent that allows CLECs a reasonable expectation of serving the mass market."<sup>76</sup> In explaining how Pacific has failed to accommodate such mass-market entry, the CPUC staff observed that:

Many carriers plan to enter the mass market through the combining of network elements or use of unbundled loops. Unfortunately, Pacific has not demonstrated that it has in place a workable method for CLECs to order and provision combined elements. Unbundled loops require termination in a collocation cage; Pacific has not made adequate collocation options available for Unbundled Network Element (UNE) combinations or unbundled loops. Further, Pacific does not yet have an automated system for processing those orders. Many of these issues are described in the report as "gating" factors. Gating factors are those barriers to robust competition that Pacific has erected through the policies and procedures it has adopted.<sup>77</sup>

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<sup>74</sup>Final Staff Report, at 2.

<sup>75</sup>Ibid.

<sup>76</sup>Ibid.

<sup>77</sup>Ibid., at 4.

The CPUC also concurred with the staff position that Pacific Bell had met only 4 of the 14 checklist requirements necessary to grant in-region intraLATA authority.<sup>78</sup> The CPUC found that “[i]n all, the picture conveyed by the late 1996 filings revealed floundering and stalled competition in the California local market...” and concluded that “[b]ecause Pacific has not opened its market to an extent that allows CLECs a reasonable opportunity to serve the mass market, competition will not reach all the segments of the telecommunications market that we and Congress intended.”<sup>79</sup>

## Measuring Local Service Competition

The final test for whether local competition is succeeding, as SBC and Bell Atlantic promised it would if their mergers were approved, is the degree to which telephone customers are actually using alternative services providers. In recent filings with the FCC, some of the RBOCs involved in currently pending mergers have portrayed the growth in local competition in recent months in breathtaking terms. Ameritech contends that local competition in its region is “vibrant,” with growth that has “exploded” and been “astounding.”<sup>80</sup> Bell Atlantic claims that it has seen a “dramatic increase in competitive entry” and is beset by a “competitive firestorm.”<sup>81</sup> There is no question that competitors have started to make some progress in penetrating some local service markets, mainly focused on business customers within the major commercial centers of larger metropolitan areas. Given that the RBOCs have been long accustomed to having legalized monopolies for local service, it is not surprising that they may see the loss of any of their local service customers as “astounding.” In fact, however, when the actual competitive inroads that have been achieved are evaluated relative to the size of the total local services markets that the RBOCs control, it is clear that competition is still in the very earliest stages of development. As explained below, the available data show that the service territories acquired by SBC and Bell Atlantic have fared no better than other areas of the country in terms of competitive entry and in some respects have performed relatively worse.

The FCC’s Common Carrier Bureau has been compiling data on the extent to which the RBOCs (and other large ILECs such as GTE) are supplying essential facilities and services to CLECs, which in turn use them to provide competitive local telephone services. Three measures are

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<sup>78</sup> Ibid., at 2.

<sup>79</sup> Ibid., at Findings of Fact Nos. 1 and 23.

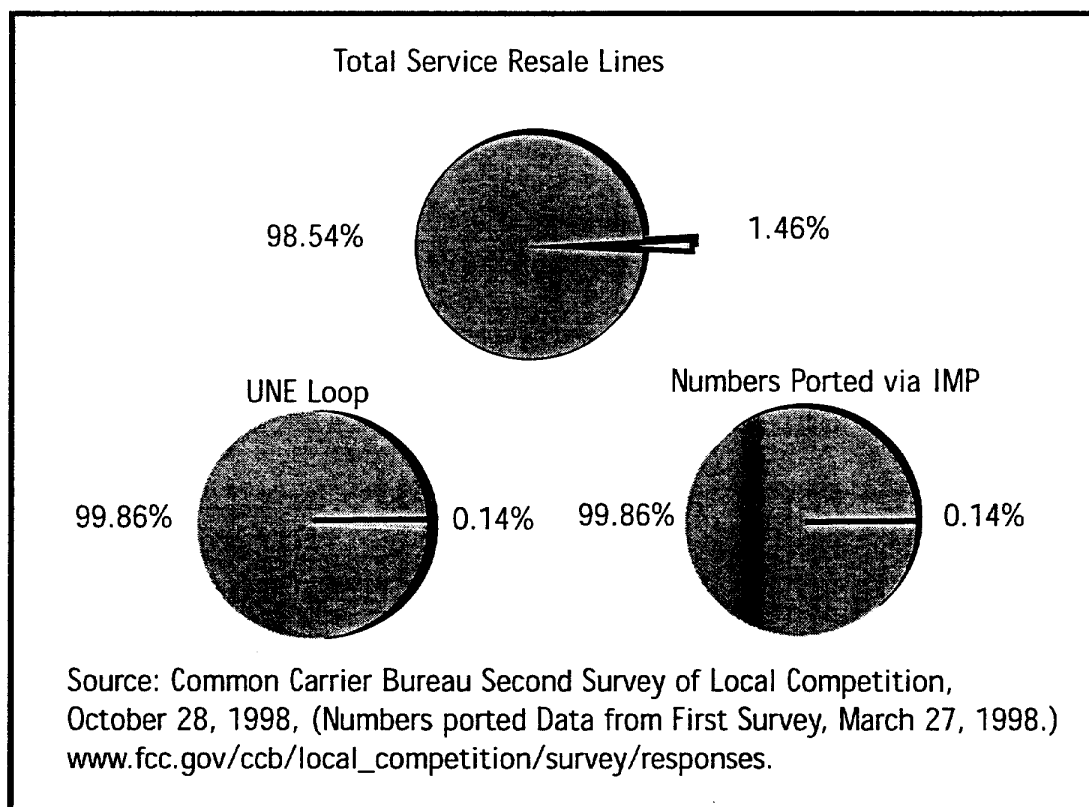
<sup>80</sup> FCC Common Carrier Docket 96-262, Ameritech Comments, October 26, 1998, at p.6.

<sup>81</sup> FCC Common Carrier Docket 96-262, Bell Atlantic Comments, October 26, 1998, at pp.8 and 10.

particularly important. “Total service resale” (TSR) lines are local exchange lines that the RBOC supplies on a discounted, wholesale basis to CLECs, who resell them as retail local telephone service to their customers. Alternatively, the CLEC may purchase only the transmission (loop) portion of an RBOC local exchange service and combine such an UNE loop with other facilities to provide retail local telephone service. Finally, when a CLEC acquires a customer formerly served by an RBOC, the customer’s telephone number must be transferred or “ported” to the CLEC, which is currently accomplished by temporary arrangements known as “interim number portability” (INP). Taken together, these three measures provide a good indication of the degree to which new entrants have been able to compete by attracting retail telephone customers away from the RBOCs.

Figure 3 below summarizes, on a nationwide basis, the latest available estimates of those measures of local competition.<sup>82</sup> As shown, within the major RBOCs’ serving areas, only about 1.5 percent of lines were being

**Figure 3: Competitive Entry into the Local Market, Nationwide.**



<sup>82</sup>The resold line and unbundled loop percentages are from the FCC’s Third Local Competition Survey, discussed in more detail below. The ported numbers percentage is derived from the First Local Competition Survey, reflecting the market status as of year-end 1997, because this measure was not included in subsequent Surveys.



resold on a total service resale basis, about 0.14 percent of local service lines were being provided over UNE loops purchased by CLECs, and about 0.14 percent of local numbers had been "ported" by RBOCs to competing local service providers via interim local number portability.<sup>83</sup> Thus, these measures indicate that, in aggregate, RBOCs continue to supply roughly 98-99 percent of the retail local telephone service provided over the existing, non-CLEC infrastructure.

The FCC does not collect data that distinguishes competitive local service provided to residential versus business customers. However, available evidence suggests that most of the local competition occurring today relates to business customers, not residential customers. Many CLECs (e.g., Teleport Communications Group, now owned by AT&T, and Metropolitan Fiber Systems, acquired by MCI) began as "competitive access providers" (CAPs) offering specialized services to long distance companies and larger businesses. In addition, most CLECs' networks have started with facilities in the higher-density regions of metropolitan areas, which tend to contain more business locations than residences. Finally, business customers typically generate much higher revenue per line than do residential customers, so that they are much more attractive to serve, particularly in the early stages of competitive entry when CLECs' capital costs and other start-up costs are high.

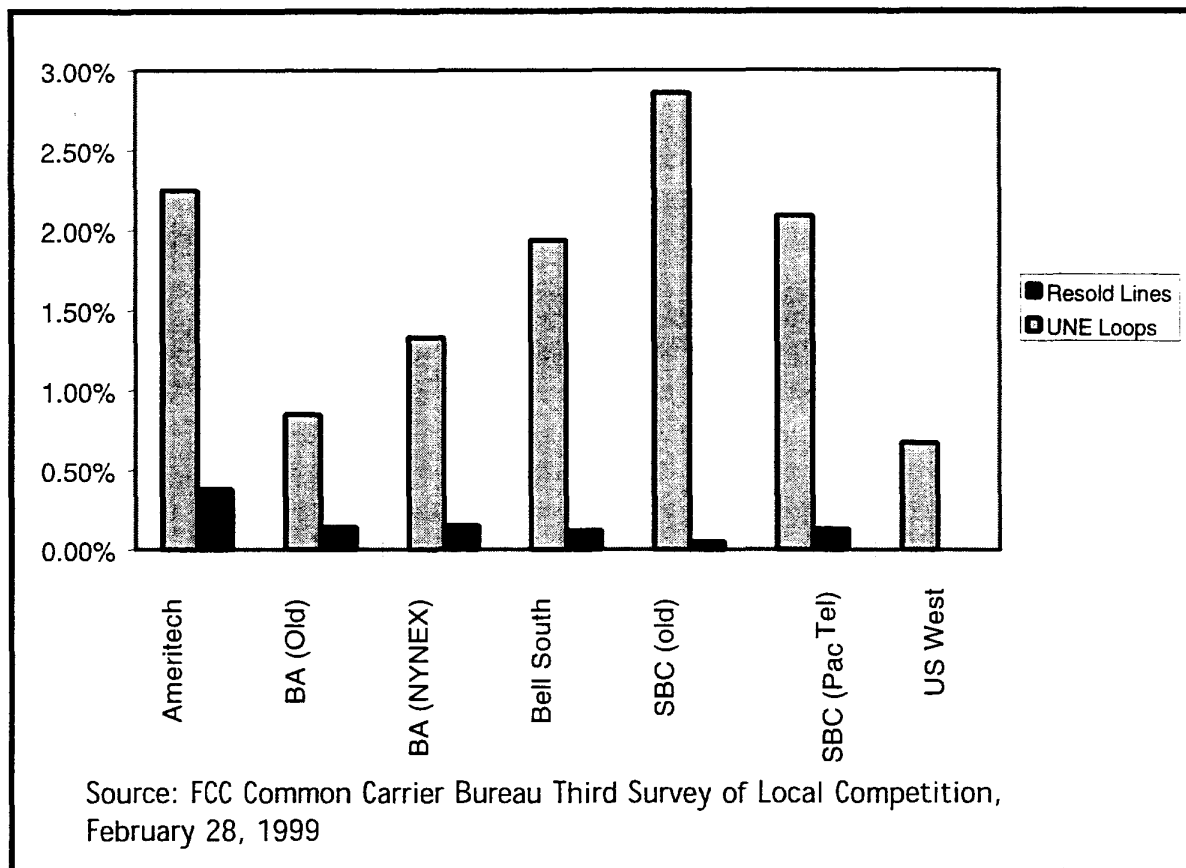
This emphasis on business customers was confirmed by a survey conducted by the National Association of State Utility Consumer Advocates (NASUCA), which found that in seven states and the District of Columbia only 22 out of 250 authorized CLECs were providing service to any residential customers. Moreover, 10 out of the 22 indicated that their residential service focused on the niche market of offering prepaid service to transients and customers with bad credit histories.<sup>84</sup>

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<sup>83</sup>The FCC's statistic for ported numbers is independent of the value for unbundled loops. Local numbers must be "ported" when an ILEC's existing local service customers take service from a CLEC that is providing its own switching and desire to keep their local phone number. The total quantity of such numbers provides a reasonable proxy for the total number of CLEC lines provided over CLEC, as opposed to ILEC, facilities. While the number does not include CLEC-provided local service lines where the customer did not desire to keep the same phone number (e.g., new service installations, out-going only trunks, and computer and fax lines), it does include some percentage of lines that are also included in the UNE loop counts (situations where the CLEC combines an ILEC UNE loop with its own switching).

<sup>84</sup> See "Reports Show Local Competition Develops Slowly, Unevenly," State Telephone Regulation Report, Vol. 16, No. 26 (December 25, 1998), at 4.

**Figure 4: Percent of Total RBOC Lines Served by CLECs Using Resold Lines or UNE Loops**



Closer examination of the FCC data confirms the RBOCs' continued dominance in local telephone markets. Figure 4 summarizes the key results of the FCC's Third Local Competition Survey, which estimates lines in service as of September 30, 1998. Figure 4 presents the FCC data by the pre-merger regional Bell holding company groups, including the former NYNEX and the former Pacific Telesis regions, to facilitate comparisons. As shown, no region, including the former NYNEX and Pacific Telesis states, has achieved more than a 3 percent share of resold lines, or a 0.4 percent share of unbundled loops.<sup>85</sup>

<sup>85</sup> In evaluating these figures, it is important to bear in mind that resold services are not "competitive losses," per se, in that the RBOC continues to furnish the underlying service even though the retail provider (who deals with the end-user customer) is a new entrant. For many products in other industries, e.g., books, supermarket foods, or pharmaceuticals, retail distribution by a non-affiliated reseller is the rule, not the exception.

While some additional number of competitively-provided lines are supplied by CLECs relying upon their own facilities, many of the CLECs report this data to the FCC on a confidential, nonpublic basis, and it is difficult to obtain from other sources due to competitive reasons and the streamlined regulation often applying to CLECs. However, SBC has estimated that, at most, slightly over one percent of the 32 million access lines in its pre-SNET seven-state operating territory are furnished by facilities-based CLECs.<sup>86</sup> An alternative measure of the extent of facilities-based local competition is to compare the total network route miles deployed by CLECs versus the RBOCs' existing infrastructures. In the July 1998 application for license transfer approvals related to the pending BC/Ameritech merger, those two companies claimed (without documentary support) that CLECs have deployed some 6500 route miles of fiber optic cable in SBC's service territory.<sup>87</sup> This figure, however, represents less than one percent of SBC's total network, which consists of over 701,651 miles.<sup>88</sup> The same limited scope of CLEC network deployment, relative to the incumbents' existing facilities, holds true for the other RBOCs as well. Data cited by the RBOCs confirm that the total network route mileage deployed by all CLECs combined amounted to only 0.9 percent of the RBOCs' total network route mileage (including fiber and copper facilities) in 1996, and two percent in 1997. These comparisons are shown graphically in Figure 5.

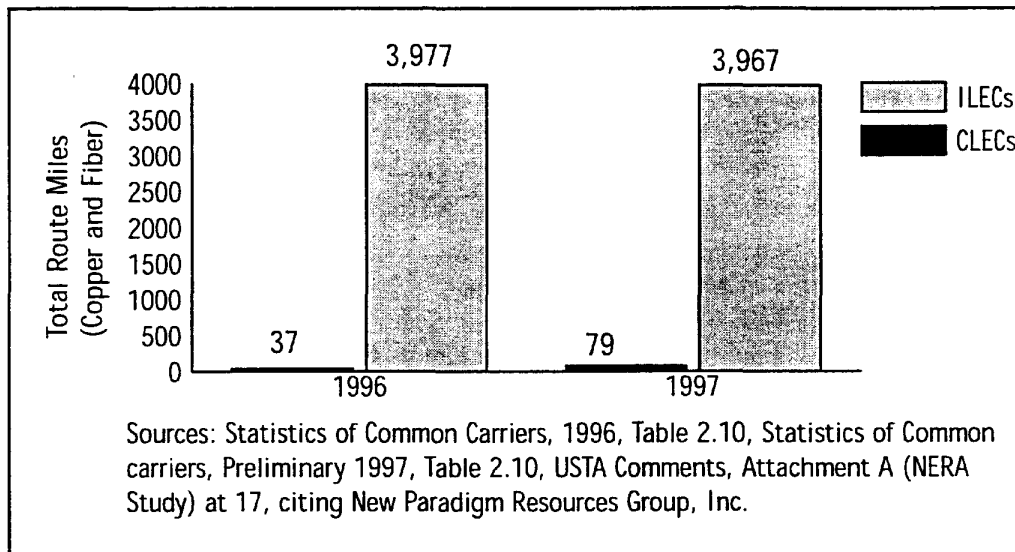
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<sup>86</sup>FCC CC Docket No. 98-141, In re Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, For Consent to Transfer Control of Corporations Holdings Commission Licenses and Authorizations Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95, and 101 of the Commission's Rules, Affidavit of Mr. Stephen M. Carter (July 24, 1998), Attachment 1, at p.1.

<sup>87</sup>Application of Ameritech Corporation and SBC Corporation Inc. for Authority, Pursuant to Part 24 of the Commission's Rules, to Transfer Control of a License Controlled by Ameritech Corporation, (July 24, 1998) ("SBC/Ameritech Merger Filing"): Applicant's Description of the Transaction, Public Interest Showing and Related Demonstrations, attached Comments Concerning the Proposed SBC-Ameritech Merger, NERA (R. Schmalensee and W. Taylor), July 21, 1998, at 22.

<sup>88</sup>FCC Common Carrier Bureau, Statistics of Common Carriers - 1997, Table 2.10. Combining the figures for SBC fiber route kilometers and copper route kilometers (km), and multiplying by the km-to-miles conversion factor of 0.6214, produces 701,651 miles.

**Figure 5: The Scope of the ILEC Networks Remains Vastly Larger than that of the CLECs.**



The SBC/Pacific Telesis and Bell Atlantic/NYNEX mergers were approved in part due to the promise of achieving several complementary public policy objectives, including the prospect of lower prices for the companies' basic local telephone services. As we observed in Chapter 2 of this report, when seeking approval of their proposed mergers, the RBOCs emphasized that merging would produce large economic benefits, and assured regulators that market forces (i.e., increasing competition) would cause a substantial share of those benefits to be passed through to consumers in the form of lower rates. This section of our report examines the extent to which the pass-through of merger-driven cost savings has occurred.

As we described in Chapter 2, when seeking merger authorization from the FCC, Bell Atlantic and NYNEX projected that, within three years of the merger, they would realize merger-driven cost savings of nearly \$1 billion per year. Bell Atlantic has been successful in attaining its cost reduction goals for the merger. Bell Atlantic's Vice President and Controller, Ms. Doreen Toben, emphasized the company's success in the context of Bell Atlantic's pending application with the FCC to merge with GTE:

Still more recently, the experience with the Bell Atlantic/NYNEX merger has reconfirmed that these merger efficiencies are real. The very substantial cost savings estimated at the time of the Bell Atlantic/NYNEX merger were subsequently increased and the increased targets are being achieved. For 1998, we projected an increased expense savings of \$450 million, and we are achieving those savings. By 2000, we projected annual expense savings of \$1.1

## **Retail Rates for Basic Telephone Service and the Flow-through of Merger Cost Savings**

### **Merger Cost Savings from Bell Atlantic/NYNEX**

billion; we are on track to achieve those savings. In addition, for 1998 and beyond, we projected annual capital savings of \$300 million; we are achieving those savings as well.<sup>89</sup>

For a number of reasons, however, it appears likely that Bell Atlantic's basic telephone service customers will receive very little from these economic benefits. First, as described in the previous section, Bell Atlantic does not have meaningful competition to compel it to lower prices. Second, in approving the merger, none of the state regulatory commissions overseeing the local telephone operations of the Bell Atlantic and NYNEX operating companies ordered rate reductions to pass through merger-related cost savings to basic telephone customers.<sup>90</sup> Third, nearly all of the post-merger Bell Atlantic's local telephone operations are subject to price regulation in which basic telephone rates are either frozen, capped, or indexed to inflation.<sup>91</sup> While some of these plans also include "productivity factors" to adjust prices to take into account anticipated annual improvements in efficiency, those factors were not revised to reflect the higher cost savings that the merger has been producing. Consequently, in the states where Bell Atlantic operates under price regulation, it generally has not undertaken basic service rate reductions or increases, other than those already required by the governing price regulation plan.<sup>92</sup> However, this does not mean that an RBOC would be prohibited from initiating a rate reduction; that is, no commission would reject an RBOC proposal to lower basic rates as a means to pass along cost savings from a merger. In New Hampshire and Vermont, the Bell Atlantic states that remain under rate of return regulation, there have been no rate cases and thus no major adjustments to basic retail rates.<sup>93</sup>

While the post-merger Bell Atlantic's cost savings have been partially offset by the costs of implementing the merger, Bell Atlantic has nevertheless been accruing large net savings from the merger rather than passing them through to basic telephone services customers in the form of lower

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<sup>89</sup>FCC CC Docket No. 98-184, Declaration of Doreen Toben, September 30, 1998 (supplied in Exhibit 4 to the Application for Transfer of Control filed by Bell Atlantic and GTE), at para. 7.

<sup>90</sup> See, e.g., the merger decisions cited in footnote 3 of this report.

<sup>91</sup> Bell Atlantic operates under price cap regulation in all seven of its traditional territories and in four out of six of the former NYNEX states. It remains subject to rate-of-return regulation in New Hampshire and Vermont. See "Earnings Regulation for Big Incumbent Telcos Just About Extinct in Eastern U.S.," State Telephone Regulation Report, Vol. 16, No. 7 (April 3, 1998) and "Price Caps Still Struggle in Western States, but '98 May See Some Changes," State Telephone Regulation Report, Vol. 16, No. 8 (April 17, 1998).

<sup>92</sup> An increase to Bell Atlantic's basic local telephone rates was approved by the Maine PUC in March 1998, but that has occurred in the context of a rate rebalancing proceeding unrelated to the merger. State Telephone Regulation Report, Vol. 16, No. 7 (April 3, 1998), at 3.

<sup>93</sup> In New Hampshire, a settlement reached in October 1997 concluded a case that had begun before the merger was approved.

rates. In 1998, Bell Atlantic realized approximately \$750 million in merger savings (\$450 million in expenses, plus \$300 million in capital savings, as indicated above), offset by \$196 million in merger-related transition and integration costs,<sup>94</sup> for net savings of about \$554 million. Bell Atlantic appears likely to achieve about the same level of net merger savings in 1999 as well.<sup>95</sup>

The SBC/Pacific Telesis merger presents somewhat different circumstances but also leads to the conclusion that the company is retaining most of the economic benefits of the merger. Like Bell Atlantic, SBC operates under price cap regulation in most of its traditional states,<sup>96</sup> none of which have experienced rate reductions for basic local telephone service due to the merger.<sup>97</sup> However, as described in Chapter 2 of this report, acting under a statute that mandated the flow-through of 50 percent of a merger's economic benefits, the California PUC ordered Pacific Bell to make rate reductions for basic telephone services as a condition of merger approval. During the CPUC review of the proposed merger, the companies estimated that their merger would achieve approximately \$366 million in net merger-related cost savings in California between 1998 and 2003.<sup>98</sup> The company study was expressly limited to operating expense savings and thus did not reflect the additional cost savings that Pacific Bell would obtain on capital purchases as a result of the merger. The CPUC estimated those additional savings to be about \$18 million per year.<sup>99</sup> In accordance with the schedule of rate reductions mandated by the CPUC's merger approval, Pacific Bell has passed through \$47 million in merger-related savings to its California customers.<sup>100</sup>

### **Merger Cost Savings from SBC/Pacific Telesis**

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<sup>94</sup> For year 1997, Bell Atlantic recorded \$519 million (pretax) in merger-related costs, \$223 million of which was (one-time) employee severance costs. In 1998, Bell Atlantic recorded \$196 million (pretax) in merger-related costs, the majority of which related to systems modifications. Bell Atlantic, 1998 Annual Report, at 9.

<sup>95</sup> Ibid., at 9. Bell Atlantic's 1998 Annual Report indicates that it expects to incur \$100-200 million (pretax) more in transition costs before it completes its merger transition activities by year-end 1999 or mid-year 2000.

<sup>96</sup> SBC operates under price caps in Arkansas, Kansas, Missouri, and Texas, and continues to be rate-of-return regulated in Oklahoma. See "Price Caps Still Struggle in Western States, but '98 May See Some Changes," State Telephone Regulation Report, Vol. 16, No.8 (April 17, 1998).

<sup>97</sup> Because SBC was the acquiring firm, the state regulatory commissions in SBC's traditional states did not undertake merger reviews during which changes to SBC's costs might have been considered.

<sup>98</sup> Ibid., at Table 1, p.2. CPUC SBC/Pacific Telesis Merger Decision, at 21. A Pacific Bell witness in that proceeding estimated the annual expense savings, net of implementation costs and "best practices" benefits, to be \$24 million in 1998 and were expected to rise to \$227 million in 2002.

<sup>99</sup> Ibid. at Table 1, p.2.

<sup>100</sup> As explained on page 14 of this report, Nevada Bell has passed through an additional \$4 million as required by the Nevada PSC, for a total of \$51 million in direct consumer benefits from the merger.

However, it now appears that the SBC/Pacific Telesis merger has produced significantly greater savings than SBC and Pacific Telesis had forecasted during the CPUC proceeding. In a roundtable discussion at the FCC earlier this year, one of SBC's economic consultants stated that "SBC has a proven track record in achieving projected cost savings. In the Pac Tel merger, they are ahead of schedule in achieving more than \$1 billion in annual cost savings by the year 2000."<sup>101</sup> In addition, the procurement savings in California had been anticipated to be 3 percent, but within only a year after the SBC/Pacific Telesis merger was finalized, SBC reported that its actual procurement savings have been in the 7-10 percent range, more than twice the original projections.<sup>102</sup> Accordingly, the \$18 million in annual capital cost savings that the CPUC had assumed actually has been in the range of \$43 million to \$61 million.<sup>103</sup> In light of this information, it appears that the CPUC-ordered rate reductions are passing through to consumers a considerably smaller portion of the net cost savings from the SBC/Pacific Telesis merger than the CPUC had intended.

Moreover, the basic rate decreases that have occurred in California may be offset relatively quickly, given that Pacific Bell also has petitioned the CPUC to increase rates. An example of a rate increase that could offset the sharing of the merger cost savings in California is Pacific Bell's Application regarding directory assistance and other operator services, such as busy line verification and emergency interrupt.<sup>104</sup> In this application, Pacific Bell seeks to decrease the monthly "free" directory assistance call allowance that is bundled into the basic monthly local service rate for residential subscribers from five to three. Because customers would be receiving less service for the same local service price, Pacific Bell's request effectively raises basic monthly rates for customers that place four or more directory assistance calls per month. In addition, Pacific Bell's application seeks to increase the cost of additional directory assistance calls, that is, the cost for each call made after a customer has fulfilled his monthly allowance of free directory assistance calls, from \$0.25 to \$0.50 per call with the additional flexibility to effect further increases up to \$1.10.

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<sup>101</sup> See FCC Docket CC-98-141, Roundtable on the Economics of Large ILEC Mergers Held on February 5, 1999, transcript, at 14-15 (Dennis Carlton).

<sup>102</sup> Connecticut Docket No. 98-02-20, SBC/SNET Merger, SBC Response to OCC-12; compare to CPUC SBC/Pacific Telesis Merger Decision, at 30.

<sup>103</sup> The CPUC estimated the annual capital savings at \$18 million by reducing overall capital costs of \$607.8 million by 3 percent. CPUC SBC/Pacific Telesis Merger Decision, at Table 1, p.2. Reducing the \$607.8 million value by 7 or 10 percent produces savings of \$43 million or \$61 million, respectively.

<sup>104</sup> Pacific Bell Application 98-05-038, In the Matter of the Application of Pacific Bell (U 1001 C), a Corporation, for Authority for Pricing Flexibility and to Increase Prices of Certain Operator Services, to Reduce the Number of Monthly Directory Assistance Call Allowances, and Adjust Prices for Four Centrex Optional Features, filed May 5, 1998.

In addition to increases in directory assistance, the application requests a rate increase for busy line verification from \$0.50 to \$2.00 per call. Such an increase would have a negative impact on certain senior citizens' programs. In a meeting with a CPUC outreach officer, the National Council of Senior Citizens of West Los Angeles described a program originating from city and county-managed senior centers wherein participants call older persons every day. When a line is persistently busy, members ask the operator to perform a busy line verification, which confirms whether the phone is in use or just "off the hook," thus implying a possible problem in the household. The centers from which these calls originate are billed for the busy line verification. The council expressed concern to the CPUC that if the rates are quadrupled to \$2.00 per call, this important program might have to be canceled due to escalating costs.

Rate stability in California has been threatened further by Pacific Bell's most recent price cap filing, in which the company requested significant changes to its regulatory framework. In this filing, Pacific Bell requested the elimination of "the remaining vestiges of earning/rate of return regulation ... including the earnings sharing mechanism, the rate of return earnings cap and floor, the 'benchmark' and 'market-based' rates of return, and the 'trigger' mechanism."<sup>105</sup> These requests were approved by the CPUC, which thus eliminated some of the ratepayer protections that were part of the prior regulatory framework. In particular, the CPUC eliminated the "earnings sharing mechanism," which required that Pacific Bell revenues over a benchmark rate-of-return must be shared with ratepayers. The implication of eliminating the sharing mechanism is that future increases in Pacific Bell's profits — which might result from merger-related cost savings, rate increases following reclassification of services as "fully competitive," and other sources — will accrue only to Pacific Bell (and its parent company SBC) and will not have to be shared with basic telephone service customers as they formerly have been.

One of the primary concerns expressed by both regulators and intervenors in the SBC/Pacific Telesis and Bell Atlantic/NYNEX merger proceedings at the state level was the impact of the proposed merger on service quality, including both traditional measures of quality of service and issues such as sales and marketing practices. This section of the report examines these measures and issues to help better understand the effects of these mergers on service quality.

## **Retail Service Quality and Pace of Network Investment**

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<sup>105</sup>Application of Pacific Bell for a Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031, February 2, 1998, at 4.



## Post-Merger Service Quality for Customers of Pacific Bell

California law requires that the CPUC assess whether a utility's change in control will maintain or improve the quality of service provided by the utility,<sup>106</sup> and the CPUC specifically addressed this issue in its final decision on the SBC/Pacific Telesis merger.<sup>107</sup> In that decision, the CPUC observed that "applicants assert Pacific's service quality will be maintained following the merger."<sup>108</sup> The CPUC acknowledged that there were persistent problems with certain aspects of Pacific Bell's service quality (having to do with the responsiveness of customer service representatives), and ultimately ordered the company to "maintain or improve its service quality over the five years following the merger" based on the existing performance standards applied to Pacific Bell, which do not apply automatic financial penalties in cases of substandard performance.<sup>109</sup> Since that time, the CPUC opened a rulemaking proceeding to develop service quality rules applicable to all telecommunications companies, after concluding that customer surveys showed a downward trend in service quality and that customer complaints to the CPUC had increased considerably over the preceding five years.<sup>110</sup> To date, the CPUC has not issued an order in that proceeding adopting new service quality rules.

While only two years have elapsed since the CPUC's merger approval, the evidence so far indicates that in the Pacific Bell and Nevada Bell (see Appendix C) regions service quality has continued to deteriorate in some respects, contrary to the promises made by SBC and Pacific Telesis. Table 1-A compares Pacific Bell's pre- and post-merger retail service quality on several measures reported to the FCC.<sup>111</sup> As shown therein, the company's average time to install local telephone service is worse than it was in 1996, prior to the merger. For residential customers, the rate of initial customer reports of a loss of service (the measure "Out-of-Service Initial Trouble Reports – per 1000 Network Access Lines) has stayed about the same, while initial reports of other types of service trouble (static, interrupted calls, etc.) have increased. (The number of business lines that Pacific Bell reported for 1998 was anomalously low and apparently in error, so Table 1-A does not present comparable trouble report rates for business customers.) The average time until resolution of an out-of-service condition (the measure "Out-of-Service Average Repair Interval,"

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<sup>106</sup>California Public Utilities Code section 854(c)(2).

<sup>107</sup>CPUC SBC/Pacific Telesis Merger Decision, at 72-76.

<sup>108</sup>*Ibid.*, at 72.

<sup>109</sup>*Ibid.*, at 74-75 and Ordering para. 2, respectively.

<sup>110</sup>CPUC Case R.98-06-029, Order Instituting Rulemaking, June 26, 1998, at 4-5.

<sup>111</sup>Performance for "percent Commitments Met", which measures the degree to which ILECs adhere to their scheduled dates for service installation, was relatively constant across 1996-1998 for Pacific Bell (and also for the Bell Atlantic regions, discussed below), and therefore was not included in the tables.

which is expressed in hours) worsened for both residential and business customers, the former by 71 percent. Finally, Table 1-A shows that the average repair intervals for other types of trouble worsened for residential customers, and improved for business customers relative to their 1996 levels.

**Table 1A: Pacific Bell Pre-and Post-Merger Service Quality**

	1996	1997	1998	Percent Change 1996-1998
<b>Local Services Provided to End Users</b>				
<b>Average Installation Interval (days)</b>				
Residence	1.9	2.8	2.2	16%
Business	3.4	4.0	3.8	12%
<b>Out-of-Service Initial Trouble Reports - per 1000 NALs</b>				
Residence	133	138	133	0%
Business	54	30	-	-
<b>All Other Initial Trouble Reports - per 1000 NALs</b>				
Residence	64	63	75	16%
Business	41	17	-	-
<b>Out-of-Service Average Repair Interval (hours)</b>				
Residence	29.3	46.8	50.0	71%
Business	14.8	16.6	17.1	16%
<b>All Other Average Repair Interval (hours)</b>				
Residence	38.0	50.0	49.2	29%
Business	20.2	16.3	14.0	-31%
Source: FCC Common Carrier Bureau - ARMIS Report 43-05, Table 2A (Pacific Bell); June 18, 1999.				

Examination of Pacific Bell's customer dissatisfaction confirms the problems suggested by the retail performance measures. Table 1-B presents the results of customer surveys that Pacific Bell reports to the FCC. These data show a pronounced increase in the percentage of dissatisfied customers between 1996 and 1998, particularly in their interactions with the company's business offices, but also with respect to service installations and repairs. The number of complaints to the CPUC concerning Pacific Bell also increased by more than 206 percent during that time (see Appendix D to this report), although some of that increase may be the result of customer confusion over who is responsible for "slamming" (unauthorized changes to a customer's selected long distance company), a situation not attributable to Pacific Bell.

**Table 1-B: Pacific Bell  
Pre- and Post-Merger Customer Dissatisfaction**

	1996	1997	1998	Percent Change 1996-1998
<b>Repairs (% Dissatisfied)</b>				
Residence	8.0	11.2	16.3	104%
Small Business	7.9	9.0	9.8	24%
Large Business	7.9	10	9.6	21%
<b>Installations (% Dissatisfied)</b>				
Residence	3.2	4.3	7.5	134%
Small Business	4.7	6.4	10.3	119%
Large Business	7.4	7.8	8.3	12%
<b>Business Office (% Dissatisfied)</b>				
Residence	2.1	2.7	6.9	229%
Small Business	4.1	5.2	9.8	139%
Large Business	2.7	7.1	7.7	185%
Source: FCC Common Carrier Bureau – ARMIS Report 43-06, Table I-A (Pacific Bell); June 18, 1999.				

The acquisition of Pacific Telesis by SBC also does not seem to have improved Pacific Bell's business practices. According to a report submitted to the CPUC in June 1998 by the Office of Ratepayer Advocates, deceptive business practices at Pacific Bell "are systematic and a great deal of pressure is brought to bear on their service representatives to adhere to the practices."<sup>112</sup> In the same month, the union representing Pacific Bell's sales employees filed a complaint with the CPUC alleging that the company had unlawfully marketed and fraudulently misrepresented the Caller ID service, had deceptively marketed and sold certain service packages, and had employed deceptive and unfair marketing practices.<sup>113</sup> Similar complaints were filed by the Utility Consumers' Action Network and the Greenlining Institute and Latino Issues Forum.<sup>114</sup> These complaints were consolidated into an investigation of Pacific Bell's marketing practices,<sup>115</sup> but to date the CPUC has not issued a ruling on the matter.

In a separate, unusual action, Pacific Bell was fined \$1.5 million in 1998 by the United States District Court as a punitive royalty payment for "misappropriation of plaintiff's confidential, computerized long distance billing information."<sup>116</sup> This judgment, issued on August 26, 1998, found that Pacific had been using the databases of its competitors AT&T, MCI, and Sprint, to which it had access because of its incumbent position in the local exchange market, to compile revenue information for over 350,000 customers with the express aim of attracting high-use customers to its own service.<sup>117</sup>

In contrast to the case of Pacific Bell, retail service quality in some of the former NYNEX states has shown significant improvement following NYNEX's merger with Bell Atlantic. Some of the most noticeable improvements have been made by Bell Atlantic's New York operating company, formerly named New York Telephone and now known as Bell Atlantic-New York (BA-NY). In 1995, the New York PSC (NYPSC) adopted an alternative regulatory framework for BA-NY called the Performance Regulatory Plan,

**Post-Merger  
Service Quality for  
Customers of Bell  
Atlantic/NYNEX**

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<sup>112</sup>Letter from Director Elena Schmid, California Office of Ratepayer Advocates, to CPUC Commissioners Bilas, Conlon, Knight, Duque, and Neeper, dated June 4, 1998.

<sup>113</sup>See CPUC Case 98-04-004 et al, Administrative Judges Ruling, June 30, 1998, at 4-5.

<sup>114</sup>*Id.* at 3-4.

<sup>115</sup>*Id.*

<sup>116</sup>AT&T Communications, et al., Plaintiffs vs. Pacific Bell, et al., Defendants, in the United States District Court for the Northern California District, No. C 96-1691 CRB, at 7.

<sup>117</sup>*Ibid.* See also "Judge Orders Pacific Bell to Pay \$1.52M for Misuse of IXCs' Data," Telecommunications Reports, August 31, 1998, at p.35.

which included a fairly elaborate program for monitoring and evaluating BA-NY's retail service quality. This program evaluates BA-NY's retail services performance on several quality dimensions, including the rates for customer trouble reports, missed appointments, and service outages, and mandates substantial rebates to BA-NY's customers when the specified performance targets are not met.<sup>118</sup>

As shown in Table 2-A, during 1996-1998, BA-NY has improved its performance on several, though not all, important service quality measures. Over this period, BA-NY has greatly reduced service installation intervals and has lowered its trouble report rates. These trends are also reflected by the steady decline in the percentage of dissatisfied BA-NY customers over the same period (see Table 2-B).

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<sup>118</sup> For example, the target level for customer trouble report rate in Manhattan central offices is 85.0%. Failure to achieve that target can trigger rebates ranging from \$5.0-million to \$25-million per year, depending upon the actual performance level. New York PSC, Case 92-C-0665, Order Approving Performance Regulatory Plan Subject to Modification by the Commission, June 16, 1995 (1995 N.Y. PUC LEXIS 296), Appendix A (Service Quality Plan), p.2.

**Table 2-A: Bell Atlantic – New York Pre- and Post-Merger  
Service Quality**

	1996	1997	1998	Percent Change 1996-1998
<b>Local Services Provided to End Users</b>				
<b>Average Installation Interval (days)</b>				
Residence	2.8	0.5	0.7	-75%
Business	5.7	1.0	1.2	-79%
<b>Out-of-Service Initial Trouble Reports - per 1000 NALs</b>				
Residence	202	171	178	-12%
Business	99	91	91	-8%
<b>All Other Initial Trouble Reports - per 1000 NALs</b>				
Residence	97	81	74	-24%
Business	41	35	32	-22%
<b>Out-of-Service Average Repair Interval (hours)</b>				
Residence	20.2	20.8	22.2	10%
Business	17.4	17.4	17.6	1%
<b>All Other Average Repair Interval (hours)</b>				
Residence	26.4	31.2	32.8	24%
Business	17.0	17.5	17.4	2%
Source: FCC Common Carrier Bureau - ARMIS Report 43-05, Table 2A (BA-New York); June 18, 1999.				

**Table 2-B: Bell Atlantic - New York**  
**Pre- and Post-Merger Customer Dissatisfaction**

	1996	1997	1998	Percent Change 1996-1998
<b>Repairs (% Dissatisfied)</b>				
Residence	26.26	20.95	12.27	-53.27%
Small Business	24.65	21.08	12.43	-49.57%
Large Business	32.06	20.99	12.49	-61.04%
<b>Installations (% Dissatisfied)</b>				
Residence	15.85	12.52	4.52	-71.48%
Small Business	23.31	18.53	9.01	-61.35%
Large Business	27.89	19.25	8.06	-71.10%
<b>Business Office (% Dissatisfied)</b>				
Residence	22.53	16.06	7.46	-66.89%
Small Business	19.38	17.29	9.40	-51.50%
Large Business	16.32	18.31	7.65	-53.13%
Source: FCC Common Carrier Bureau – ARMIS Report 43-05, Table 2A (BA-New York); June 18, 1999.				

Bell Atlantic-Massachusetts has achieved roughly similar improvements in those measures of service quality and customer satisfaction during the 1996-1998 timeframe (see Table 3-A and 3-B). Like BA-NY, BA-Massachusetts faces automatic financial penalties for substandard service quality performance. In Massachusetts, these take the form of a "Service Quality Index" component to the company's price cap regulation plan.<sup>119</sup>

<sup>119</sup>See Mass. DPU 94-50, Order, May 12, 1995, at 238.

**Table 3-A: Bell Atlantic - Massachusetts Pre- and Post-Merger Service**

	1996	1997	1998	Percent Change 1996-1998
<b>Local Services Provided to End Users</b>				
<b>Average Installation Interval (days)</b>				
Residence	3.5	2.1	1.9	-46%
Business	4.3	2.5	2.3	-47%
<b>Out-of-Service Initial Trouble Reports - per 1000 NALs</b>				
Residence	174	155	152	-13%
Business	83	73	73	-12%
<b>All Other Initial Trouble Reports - per 1000 NALs</b>				
Residence	74	58	56	-24%
Business	41	26	24	-41%
<b>Out-of-Service Average Repair Interval (hours)</b>				
Residence	33.0	25.3	24.8	-25%
Business	16.3	13.4	12.2	-25%
<b>All Other Average Repair Interval (hours)</b>				
Residence	21.4	19.5	24.4	14%
Business	10.0	8.2	10.3	3%
Source: FCC Common Carrier Bureau - ARMIS Report 43-05, Table 2A (BA-Massachusetts); June 18, 1999				



**Table 3-B: Bell Atlantic - Massachusetts Pre- and Post-Merger  
Customer Dissatisfaction**

	1996	1997	1998	Percent Change 1996-1998
<b>Repairs: % Dissatisfied</b>				
Residence	33.85	28.00	15.63	-53.83%
Small Business	22.97	19.68	10.26	-55.33%
Large Business	29.38	22.05	16.45	-44.01%
<b>Installations: % Dissatisfied</b>				
Residence	12.56	11.27	4.83	-61.54%
Small Business	18.54	16.95	7.63	-58.85%
Large Business	22.24	16.29	8.15	-63.35%
<b>Business Office: % Dissatisfied</b>				
Residence	10.07	9.69	5.21	-48.26%
Small Business	12.56	11.53	6.44	-48.73%
Large Business	10.88	19.51	10.37	-4.69%
Source: FCC Common Carrier Bureau – ARMIS Report 43-05, Table 2A (BA-Massachusetts).				

As has been the case in New York and Massachusetts, the percentage of dissatisfied customers in the other former NYNEX states has declined dramatically between 1996 and 1998 (See Appendix B to this report, which contains tables of retail service quality data for Bell Atlantic in Maine, New Hampshire, Rhode Island, and Vermont). The number of customer complaints also has been reduced significantly in all of the former NYNEX states (See Appendix C to this report). Interestingly, however, Bell Atlantic's performance on the service quality measures does not exhibit the same patterns of improvement in the other former NYNEX states that are evident in New York and Massachusetts, and in particular instances shows some signs of deterioration. While Bell Atlantic reports improvement in installation intervals for its operations in the remaining four New England states, the average repair intervals have grown in Maine, for example, and Vermont shows a mixed record. The time elapsed since the merger is brief, and thus the data are preliminary. The data do suggest, however, that Bell Atlantic's management has been more responsive to state regulators' concerns over service quality when those concerns have been backed by a rigorous quality monitoring and enforcement program.

Among the various state utility commissions in the Bell Atlantic/NYNEX region, the New York PSC appears to have established a particularly good framework with which to evaluate the effects of the merger on the quality of services provided by Bell Atlantic. The traditional measures discussed above focus on retail service quality.<sup>120</sup> Recently, however, the NYPSC expanded its service quality monitoring process to encompass intercarrier services that CLECs purchase from BA-NY in order to provide competitive local service. The NYPSC adopted an initial set of new measures developed by a working group of carrier representatives. Accordingly, BA-NY must now meet specific performance standards for such items as wholesale service order accuracy, wholesale billing accuracy, and the percentage of BA-NY-to-CLEC service cutovers in real-time (known as "hot" cutovers) which are completed on schedule.<sup>121</sup> However, the NYPSC has declined to adopt performance penalties in this area and has directed the working group to continue its consideration of additional performance measures and issues.<sup>122</sup>

This chapter has examined the post-merger performance of SBC/Pacific Telesis and Bell Atlantic/NYNEX relative to the three issues that presented the greatest regulatory concerns, namely the RBOCs' removal of barriers to competitive entry into local telephone service markets, their pass-through of merger cost savings, and the preservation of service quality. As described in Chapter 2, during the regulatory reviews of their merger proposals, the RBOCs made assurances and/or commitments bearing on each of the three areas, several of which were adopted by regulators as conditions for merger approval. While the full impacts of the mergers probably will not be realized for several more years, our preliminary analysis shows that the RBOCs' performance has not been meeting expectations in several respects, and that thus far consumers have received few tangible benefits from either merger. Our specific findings include the following:

## Summary

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<sup>120</sup> The FCC also compiles data on the quality of the ILEC services offered to toll services providers (i.e., switched and special access services), as well as data on network reliability. See, e.g., Tables I-A and IV-A of the ARMIS 43-05 reports. We have not attempted to analyze these data for this report due to time and resource constraints.

<sup>121</sup> New York PSC, Case 97-C-0139, Order Adopting Inter-Carrier Service Quality Guidelines, February 16, 1999 (mimeo), pps.6-8.

<sup>122</sup> Ibid., at p.3 and Appendix 3.

- Each of the merging companies contended that their mergers were pro-competitive. In seeking regulatory approval from the FCC, Bell Atlantic/NYNEX pledged to undertake nine local market-opening actions. Thus far, the company has fulfilled some of its commitments. Some of the other market-opening actions, however, have proven to be ineffective and/or impractical to enforce. Overall, in spite of the promises made by the RBOCs to open their local markets to competition and the application of the FCC's nine market-opening actions, local competition is not noticeably more advanced in the former NYNEX regions compared to other parts of the country. In California, local telephone service competition is also developing slowly. The CPUC concluded this is due in part to shortcomings in Pacific Bell's efforts to accommodate new market entrants. In the two years that have passed since the Bell Atlantic/NYNEX and SBC/Pacific Telesis mergers were approved, competing local service providers have had difficulty penetrating the merged RBOCs' markets. As a result, most consumers in the acquired RBOC regions have seen little growth in their choices for local telephone service.

- The merged companies have achieved and even surpassed their targets for merger-driven cost savings, but only a small portion of these benefits has been passed through to consumers in the form of lower prices for basic telephone service. Bell Atlantic's merger was not subjected to any specific flow-through requirements, and it has not reduced basic service rates other than as required by its pre-existing price regulation plans. While Pacific Bell has been complying with the California PUC's schedule of mandated rate reductions, its actual cost savings are considerably higher than the company's earlier projections; and nevertheless, Pacific has pushed for higher rates and greater pricing flexibility for a number of its retail services.

- Pacific Bell's retail service quality has slipped in several respects since the SBC merger. Bell Atlantic has had a mixed record of post-merger service quality, with pronounced improvement on some quality measures in two former NYNEX states, New York and Massachusetts, where regulators have specified performance objectives and mechanisms for financial accountability when performance is substandard.

## CONCLUSION

The circumstances surrounding the Bell Atlantic/NYNEX merger are, in many ways, different and independent of the circumstances surrounding the SBC/Pacific Telesis merger. The performance of the two merged entities also has differed in many respects. In general, however, several conclusions can be made with regard to how well the merged companies have thus far fulfilled the promises and commitments they made during the regulatory review process. Our overall conclusion is that, despite varying attempts by the state PUCs and federal regulators to serve the public interest when approving the RBOC mergers, consumers to date have received relatively few tangible benefits from the mergers. As described in the previous chapter, some of the specific commitments made by the merging RBOCs as a condition of regulatory approval either have not been met or have proven insufficient, particularly with respect to opening their local service markets to competition. Moreover, the concentration of market power in the merged RBOCs creates powerful incentives to continue to limit competitive entry, increase rates charged to captive customers, and cut back on service quality whenever it is profitable to do so. In SBC's case, these incentives are increased because of the financial pressures created by the high premiums paid for their acquisition. For these reasons, state and federal policy makers need to ensure that ubiquitous, effective competition for local telephone service exists or may develop without hindrance before the RBOCs are allowed to merge.

It is, of course, too late to "undo" the completed Pacific Telesis and NYNEX acquisitions. However, there are still opportunities for regulators to improve their protection of consumers from the detrimental trends identified above, both with respect to the two mergers that served as the focus of this paper and during the ongoing reviews of the proposed Bell Atlantic/GTE and SBC/Ameritech mergers. Our recommendations are as follows:

- First, regulators should seek to quantify in more precise terms the full extent of the cost savings and efficiency improvements that the acquiring firms realize from the mergers and identify, in particular, the savings that are attributable to improvements in the provisioning of basic exchange services. Because these services are not likely to face widespread, price-constraining competition in the foreseeable

future, regulators should adjust the productivity assumptions contained in the firms' incentive regulation plans to ensure that those savings are passed through to basic exchange customers.<sup>123</sup>

- Second, while regulators have already expended considerable effort in this area, they should carefully continue to monitor the firms' service quality and be prepared to take assertive actions, including imposition of financial penalties when appropriate, to encourage the firms to comply with mandated quality standards. Designating a carrier working group to devise wholesale services standards, as the New York PSC has done, for example (see Chapter 3), appears to be an effective approach, although determining nonperformance penalties in this area probably requires direct action by regulators.
- Third, regulators should consider extending the more effective of the local market-opening initiatives that the FCC adopted for Bell Atlantic to the SBC/Pacific Telesis merger and to any subsequent RBOC mergers that receive approval. As outlined in this report, some of these conditions are flawed. Others, however, appear to be reducing some of the barriers to the development of a competitive market in the Bell Atlantic region and may serve as a useful starting point for creating more effective conditions.
- Fourth, regulators should use the Telecommunications Act's 14-point checklist for local competition as a benchmark for approving RBOC mergers.
- Fifth, and perhaps most important, is that regulators at the state and the federal level must devise ways to hold these companies' accountable for the promises they make while seeking regulatory approval. The following actions could help to improve accountability:

- adopt concrete and verifiable conditions instead of accepting ill-defined commitments to future action;

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<sup>123</sup>For example, the CPUC should make a significant upward increase to the "X-factor" productivity offset value contained in the SBC's New Regulatory Frameworks incentive regulation plan.

- use self-executing sanctions when such conditions are not met, in order to raise the profile and credibility of enforcement. For example, claims that a merger will result in improved service quality should be backed up by penalties that are automatically implemented when commitments to achieve specific performance levels are not met;
- impose sanctions that are strong enough to deter violators from choosing to accept the punishment over meeting the condition.

Our final conclusion, however, is that even the best-constructed regulatory conditions are unlikely to defuse the potential anticompetitive and anticonsumer impacts of mergers between RBOCs. In this regard, the only way to ensure that consumers actually share in any benefits of an RBOC merger, including more choices, improved service quality, and lower prices, is for regulators to approve only those RBOC mergers for which effective competition exists throughout the combined region.